

Unrelated trade or business; retail grocery store. An exempt organization's operation of a retail grocery store as part of its therapeutic program for emotionally disturbed adolescents, almost fully staffed by the adolescents, and on a scale no larger than is reasonably necessary for the performance of the organization's exempt functions, is not unrelated trade or business within the meaning of section 513 of the Code; Rev. Rul. 73-127 distinguished.

Advice has been requested whether, under the circumstances described below, the operation of a retail grocery store is unrelated trade or business within the meaning of section 513 of the Internal Revenue Code of 1954.

The organization, exempt from Federal income tax under section 501(c)(3) of the Code, was formed for the purpose of providing a residence facility and a therapeutic program for emotionally disturbed adolescents. The organization's psychiatrists provide individual, group, and vocational therapy for the residents.

As part of its program, the organization operates a grocery store under the supervision of a manager who is experienced in both the retail food industry and in working with disturbed adolescents. All other employees are emotionally disturbed adolescents who are participating in the organization's program. Employees are promoted to various positions in the store based on a system of evaluation whereby an employee's achievements are rated by the manager and the other employees. Achievement in the store plays an important role in determining the privileges that are granted to the adolescents by the staff of the residence as well as the progress of the adolescents toward reintegration into the community. The adolescents are paid for working in the store, and thus are able to defray a portion of the cost of their care and treatment.

The grocery store is operated at a level to utilize only the number of adolescents residing at the facility. The training program connected with the store is not operated primarily to provide vocational or occupational rehabilitation but rather to help the adolescent become a responsible and self-supporting citizen. Thus, the development of job skills is secondary to the goal of emotional rehabilitation of the adolescents through job satisfaction and personal achievement.

Section 513(a) of the Code defines the term 'unrelated trade or business' as any trade or business of an organization subject to tax under section 511 the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt functions.

Section 1.513-1(d)(2) of the Income Tax Regulations states

that trade or business is 'related' to exempt purposes only where the conduct of the business activity has causal relationship to the achievement of an exempt purpose, and is 'substantially related' for purposes of section 513 of the Code only if the causal relationship is a substantial one. Thus, for the conduct of trade or business to be substantially related to the purposes for which exemption is granted, the performance of services must contribute importantly to the accomplishment of those purposes.

Section 1.513-1(d)(3) of the regulations states that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business.

The organization's training program connected with operation of the grocery store provides the emotionally disturbed adolescents an opportunity to respond to the psychiatric treatment of their emotional problems, and thus become able to be reintegrated into the community. The operation of the grocery store enables the resident adolescents to become involved with society, assume responsibility, and exercise business judgment, all of which contributes to their rehabilitation.

This organization's activities are distinguishable from the grocery store operation in Rev. Rul. 73-127, 1973-1 C.B. 221. The organization in that Revenue Ruling was formed to operate a retail grocery store to sell foods to residents of a poverty area at prices substantially lower than those charged by competing grocery stores, to provide free grocery delivery service to residents who need it, to participate in the Federal food stamp program, and to provide job training for unemployed residents of the area. Rev. Rul. 73-127 concludes that the organization does not qualify for exemption as an organization described in section 501(c)(3) of the Code because under the facts the grocery store operation was being conducted on a much larger scale than reasonably necessary for the organization's training program, thereby precluding the organization from being organized and operated exclusively for charitable purposes.

However, the grocery store operated by this organization is almost fully staffed by the adolescent residents, and thus is operated on a scale no larger than is reasonably necessary for the organization's training and rehabilitation program.

Accordingly, the organization's operation of the grocery store contributes importantly to the organization's charitable

program and is not unrelated trade or business under section 513 of the Code.

Rev. Rul. 73-127 is distinguished.